

State Taxation of Partnerships

December 10, 2021



MULTISTATE TAX COMMISSION

Project Plan

The project work group has outlined a general approach to the project:

1. Identify and generally describe a comprehensive list of potential issues.
2. Note the important relationships between those issues.
3. Select a particular issue and develop generally recommended practices or positions.
4. Repeat step 3 until all major issues have been addressed and reconcile any differences.
5. Agree on overall set of recommended practices/positions for all issues.
6. Begin creating draft models, etc., to carry out the recommended practices/positions.

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Last Call – Finished Issue Outline

- Issue Outline:
 - Identifies and generally describes a list of the issues.
 - Notes important relationships between them.
 - Also gives some background and analysis



Last Call –
Discussed
Survey

No strong consensus
about which issues are
most important or
where we should start.

General agreement that
training, especially on
federal tax treatment,
would be useful.



Asked Uniformity Committee for Any Direction

- Meeting on November 9
- Discussion, but no strong sense of one issue to begin with
- Staff made a proposal:
 - Investment partnership white paper
 - Training - basics of Subchapter K

Reasons for Staff Proposal

- Investment Partnership White Paper
 - Majority of states recognize need for special rules.
 - Policy aims are similar, but rules differ somewhat.
 - States could benefit from sharing experiences.
 - There are implications for other issues.
 - Most importantly – the issue doesn't raise some of the difficulties that others will.
- Subchapter K Training – Basics for Tax Administrators
 - States consistently express an interest in training.
 - Will help states in evaluating difficult issues.

Investment Partnerships

What are we talking about?

- First – a majority of states provide that some defined “investment partnerships” or “qualified investment partnerships” are subject to special rules –
 - Nonresident/non-domiciliary limited partners may not be deemed to have nexus in or be doing business in the state, and/or
 - Investment partnership income may be excluded from nonresident/ non-domiciliary partners subject to sourcing to the state, even if partnership has activities there.



Investment Partnerships

What are we talking about?

- Second – state treatment differs somewhat –
 - The definition, which usually relies on the type of assets held and type of income recognized
 - Whether corporate limited partners are treated the same as individual limited partners
 - How any non-investment income may be sourced
 - How rules apply in tiered partnership structures





Investment Partnerships Bigger Picture

- Preliminary thoughts:
 - SEC regulated entities – including entities that are regulated investment companies, including mutual funds, and similar entities (e.g. REITS) are typically formed as corporations and are subject to special hybrid rules – Subchapter M.
 - Other less regulated investment-type entities are often organized as limited partnerships or LLCs. With minor exceptions, they are taxed as other partnerships under Subchapter K. These include hedge funds and private equity funds.
 - But that's not all . . .



Investment Partnerships Bigger Picture

- Preliminary thoughts:
 - There are numerous examples of closely held or specialized partnership structures that engage in similar investment activities—or that may be formed to hold investments.
 - But –
 - Just because a partnership has investments doesn't make it an investment entity
 - Just because a partnership has investors (limited partners) doesn't make it an investment entity
 - Just because the partnership is a special purpose holding company for an investment in another business doesn't make it an investment entity



Investment Partnerships Bigger Picture

- What data appears to show:
 - The investment industry sector – broadly defined – generates most of the federal income reported by partnerships (roughly 70%)
 - Hedge funds and private equity funds constitute only about 1/3 of this industry sector.
 - These other partnerships in this industry sector appear to be less transparent even than hedge funds or other similar non-regulated investment entities.
 - Some of the other partnerships are likely special purpose entities or holding companies used by closely related parties.
 - Some data shows that this is where many of the most complex partnership structures may exist.



Investment Partnerships Other Thoughts

- Besides the rules for sourcing income, the treatment of investment partnerships implicates:
 - Whether investment partnership income retains its character as it flows through
 - How PTE taxes may apply
 - Whether resident investors would be entitled to a credit for taxes paid
 - How income of general partners or managing members is treated
 - Enforcement and oversight—including information reporting and sharing information between states, etc.
 - How state rules impacted by Subchapter K conformity and certain special rules for investment partnerships as defined (e.g. IRC 721 and 731).



Investment Partnerships

- Bottom line –

- It appears there are policy reasons to simplify the reporting of income from certain types of investment partnerships and to treat that income similarly regardless of the form of the entity.
- However, it also appears that this treatment should be adequately limited to match those policy goals and that states may need to consider best practices for this purpose.

Subchapter K Training

What are we talking about?

- Recorded sessions provided to state personnel that wish to participate in the training—initially free of cost
- At least two live question and answer sessions
- Provided between now and the MTC meetings in April
- Focusing on basic understanding of the Subchapter K rules that have implications for state taxation



Training Syllabus –

12 One Hour
Sessions

Session 1:

Introduction & Legal Nature of Partnerships

Session 2:

Survey of Partnership Data, Choice of Entity,
and Structure

Sessions 3-12:

Subchapter K Basics – Focusing on the Federal
Rules that have State Tax Implications

Sessions 3 - 12:

Subchapter K –
the Basics

- Terminology
- General Policy
- Importance of Recordkeeping & Accounting (Intro to Basis and Capital Accounts)
- Formation
- Recognition, Valuation, and Characterization of Partnership Items
- Certain Partner-Partnership Transactions
- Separate Statement of Partnership Items
- Intro to Distributive Share
- Distributive Share – Partner's Interest in Partnership

Sessions 3 - 12:

Subchapter K –
the Basics
(continued)

- Special Allocations
- Substantial Economic Effect
- IRC 704(c) and Contributed Property
- Other Special Allocation Anti-Abuse Rules
- Case Studies – Special Allocations
- Partnership Liabilities – Generally
- Distributions – Current & Liquidating
- Recap on Outside Basis
- Recap on Partner Accounts

Sessions 3 - 12:

Subchapter K –
the Basics
(continued)

- Changes in Partners – Incoming Partners
- Changes in Partners – Sale of Partnership Interest
- Changes in Partners – Reorganizations
- Other Anti-Abuse Rules and Their Use
- Tiered Partnerships – Generally
- Tiered Partnerships – Special Problems
- Schedule K-1 and Partnership Reporting
- Affect of Partnership Items on Individual Partners
- Affect of Partnership Items on Corporate Partners
- Comprehensive Case Study

Thoughts?



(Seriously . . . you won't offend us.)